Penalty regime for VAT returns to be overhauled in 2022.

Last week's Budget included confirmation of a new penalty regime for the late submission and payment of VAT returns.

First mooted in 2016, the new system will come into effect for VAT return periods beginning on or after 1 April 2022 and will bring VAT more closely in line with existing penalties which apply to direct tax returns.

Currently, late submission and payment of VAT returns are penalised by a single default surcharge, which is calculated as a percentage of the VAT due on the return. Businesses receive a surcharge liability notice for the first default, and subsequent defaults are successively surcharged at 2%, 5% and 10% up to maximum of 15%. However, the surcharge is imposed at a fixed amount for a late filing – it does not increase according to how late the return is submitted, and no interest is charged on late payments.

Default surcharges are something of a blunt instrument for punishing VAT compliance failures. They can result in unexpectedly large fines for those who submit and/or pay their VAT return just a few days late, often in error rather than because the business is unable or unwilling to pay the VAT due.

The resultant appeals have kept HMRC and the tribunals very busy over the years. In one extreme case, a part-time landlord received a surcharge of £217,000 for a return submitted only five days late because a default coincided with a period containing a large VAT liability from the sale of a property.

This was a nasty surprise for the landlord, who had been expecting a fine more akin to the £100 penalty for filing a late income tax return but, on appeal, the First Tier Tribunal (FTT) found they did not have a reasonable excuse defence for the late filing of the return and so declined to overturn the surcharge on proportionality grounds.

Such a situation could not arise under HMRC's new regime, which will impose up to four different but potentially parallel charges on businesses that do not submit and/or pay their returns on time.

Late submission penalty – HMRC will issue a single penalty point for a late submission of a VAT return and, once the business has exceeded a points threshold for multiple missed returns, a flat penalty of £200 will be imposed for each late return.

Late payment penalties – this will be a two-part penalty. The first charge will be imposed at 2% of the outstanding tax if the tax due on a return remains unpaid 15 days after its due date. If any of this tax is still unpaid after 30 days, the penalty increases to 4% of the tax still outstanding at that point. The second charge is a daily penalty (set at 4% per year on the outstanding amount) starting from 31 days after its due date until the business pays the tax that is due.

Late payment interest (calculated at 2.5% above the Bank of England base rate) will be payable on tax outstanding after the due date for a VAT return. Where a payment is made after the due date, late payment interest will be payable from the due date until the date full payment of that tax is received by HMRC.

This is a fairer system which will be welcomed by most taxpayers, but there will still be winners and losers when the new system comes into force. The new regime is good news for businesses who might occasionally submit and/or pay their VAT return less than 15 days late (for example, because of an administrative or bank error or a short cashflow-related delay) as they will only incur relatively small amounts of penalties and interest.

By contrast, it will be bad news for businesses who are struggling to pay their VAT returns at all and are frequently more than 30 days late settling the tax due. These businesses could find themselves caught up in a complex web of escalating penalties from which it may be difficult to escape. The daily penalty imposed once a VAT return payment has been outstanding for more than 30 days will be particularly punitive.

HMRC objectives

HMRC appears to have two aims here. Firstly, it is no doubt seeking to cut down on the large number of surcharge-related appeals that make it as far as a tribunal, which are predominantly fought by healthier businesses who make an occasional mistake.

Second, by offering reduced penalties to those who seek help quickly, HMRC also seems keen to encourage long-term late payers to enter into formal ‘time to pay’ arrangements. But even this will not save taxpayers who are in such trouble they fall behind on an individually negotiated ‘time to pay’ agreement, and that situation may become more common as many businesses struggle in the aftermath of the coronavirus.